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SUBJECT: LATVIA'S 2010 BUDGET PASSES FIRST HURDLE

REF: A. RIGA 516, B. RIGA 484, C. STOCKHOLM 632, D. RIGA 413

SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) Summary: The Latvian parliament (Saeima) voted in favor (64-32-1) of the government's 2010 budget at the first reading of the bill on November 5. Consultations between the government and the IMF and EC are still ongoing and there remain disagreements in the coalition about tax reform and expense cuts. The draft law is likely to elicit a record number of proposed amendments and undergo significant changes going into the second and final readings scheduled for December 1. Passing the budget in the first reading sends a positive signal, but significant challenges remain. End Summary.

THE BASICS  
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¶2. (SBU) The Saeima adopted the government's 2010 budget on November 5th in the first reading. The draft law received 64 votes in favor, 32 against and one abstention. Votes were cast strictly following coalition - opposition lines, except for one opposition MP who abstained. The budget package was given urgent status under parliamentary rules. Consequently, amendments can only be submitted only until November 9th. The second reading date was set for December 1st.

¶3. (SBU) The draft budget estimates revenues at LVL 3.8 billion (USD 8.1 billion) and expenses at LVL 4.3 billion (USD 9.1 billion) which would result in a 6.1% cash flow deficit. These projections are still under scrutiny by the IMF. The proposed budget assumes 3.7 percent deflation, 13.8 percent unemployment and estimates 2010 GDP at LVL 11.9 billion (USD 25.3 billion), which represents a 4 percent contraction of GDP. These figures are consistent with the IMF's economic outlook.

PARLAMENTARY DEBATES REVEAL TENSION  
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¶4. (SBU) In his address to the Saeima, Prime Minister Dombrovskis acknowledged that there is widespread discontent with the budget and termed it a 'crisis budget' that reflects the limited resources available to the state. Dombrovskis said he is confident that there is no better alternative to stabilizing the Latvian economy and reiterated his commitment to work with international lenders. Dombrovskis explained that international assistance is allowing Latvia to undergo gradual fiscal consolidation as opposed to the more drastic measures that would be necessary without it, and highlighted that turning to the IMF was Latvia's choice. Dombrovskis also addressed devaluation and said that Latvia is committed to keeping the lat stable. He said there is both the political will and sufficient resources at the Bank of Latvia to keep this commitment.

15. (SBU) The lengthy debates that followed the Prime Minister's address revealed the extent of disagreement that still exists within the governing coalition regarding specific budget details. Although the budget was voted on as presented, individual Saeima members used the session to outline the amendments they will be proposing as the process moves forward. For example, Vineta Muizniece, the Faction Head of the People's Party (which currently controls 19 seats), said her party objects to a tax on personal use of company automobiles, and the proposed distribution of Personal Income Tax (PIT) revenues among the central and local governments.

16. (SBU) The most contentious issue for debate moving forward will likely be the Personal Income Tax reform. Muizniece expressed strong disapproval to the proposed reduction in the tax-exempt deductible amount. According to her, People's Party will propose instead to replace this regressive measure with a raising the flat PIT rate from the current 23 percent back to its previous rate 25 percent. Soon after, the Civic Union party (which holds six seats) announced they will propose a progressive income tax that would start at 18 percent and reach a 34 percent for the highest income earners.

17. (SBU) Harmony Center, the largest opposition party (with 18 seats), declared they will submit their own version of the budget. Harmony Center proposed a progressive income tax, keeping corporate income tax at 15 percent, lowering the VAT to 18 percent from 21 percent, no increase in excise taxes, increasing the efficiency of tax collection, and lowering the social security tax. On the expenditure side, Harmony Center proposed cutting all military operations abroad, reducing expenses related to top defense officials, cutting public sector salaries by 20 percent compared to pre-crisis levels, and consolidating the number of ministries to 7. It is unclear whether Harmony Center will submit their ideas as a complete alternative budget proposal to the Saeima or as a series of amendments.

#### CONSULTATIONS WITH INTERNATIONAL LENDERS CONTINUE

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18. (SBU) Despite the passage of the budget in the first reading, there still remain significant differences between the IMF/EU and the government over the effectiveness of the proposed budget. The differences concern roughly LVL 150-200 million (USD 320-440 million) or nearly 40 percent of the total budget. While exact details remain unavailable, among the concerns are the regressive nature of several proposed tax measures and the across the board nature of expenditure cuts. In general, the IMF is reviewing the budget measures to determine which ones represent carry-over from 2009 budget adjustment versus new measures. In addition, they are looking at what the 2011 impact of the measures will be to determine how sustainable and structural the adjustments are. The government and the international lenders agreed to work out the differences during the budget amendment process, rather to push for a further delay in its submission to Saeima. The IMF's Second Review team is anticipated to arrive in Riga before the end of November.

#### CRITICAL DAYS AHEAD

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19. (SBU) Comment: Adopting a credible budget that is supported by its international partners is crucially important for Latvia. Passing the budget in the first reading was an important step that sends a positive signal. However, the next few days and weeks will be critical in determining whether the government and lenders can agree on a final budget and whether there will be sufficient political support for the agreement to pass in the second and final reading.

GARBER